Internal Revenue Service memorandum CC:LM:CTM:SF:POSTF-103538-02 BAKranzthor March 7, 2002 date: Bonnie Barber, International Examiner to: Area Counsel from: (Communications, Technology, and Media: Oakland) subject: Form 1120, Taxable Year Ended (TYE) You requested our consideration of the following question: What is the gross sales price for the sale [in TYE])? There is a non-competition assets of (subsidiary of agreement for \$ and a license agreement for \$ Should these amounts be included in the total gross sales price for the operating assets, or are they separate? You also stated that the purpose for this question is to determine whether the taxpayer has established that it is entitled to a worthless stock deduction in the TYE In our opinion the taxpayer has not established that it is entitled to a worthless stock covenant not to compete should not be respected for tax purposes. Moreover, the taxpayer's estimate of "closure costs" should also be disregarded. We do not, however, have enough information to determine whether or not the licensing agreement should be respected. **FACTS:** The U.S. parent company, claimed a worthless stock deduction of \$ in its TYE subsidiary, representing its investment in its ¹ In support of its claimed deduction the taxpayer submitted an appraisal report prepared by (The report, dated concluded that was worthless as of because its Total Liabilities of ¹ This comes close to the amount of common stock shown in an appraisal report prepared for the taxpayer by . using as the to-\$ exchange rate as of

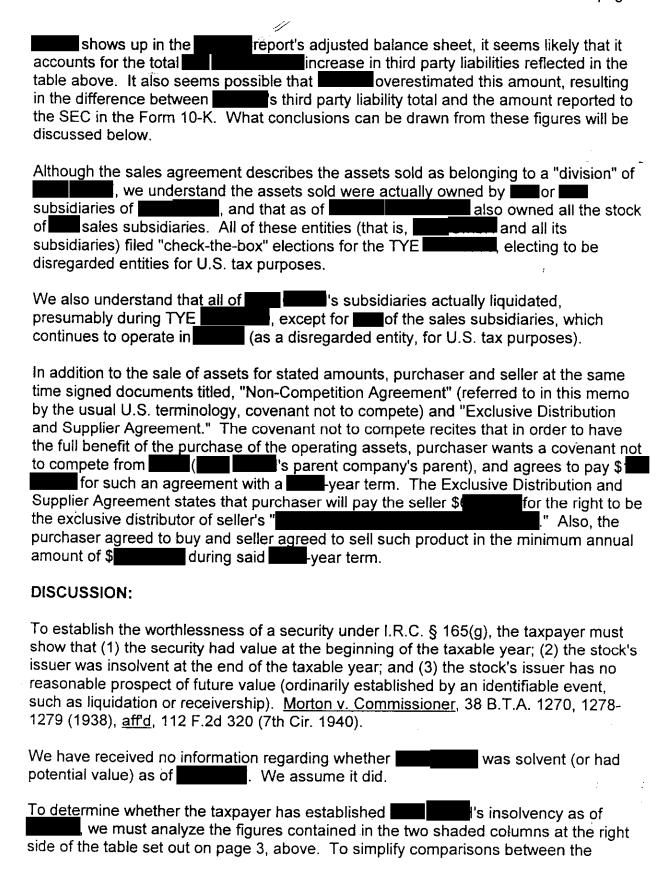
Office of Chief Counsel

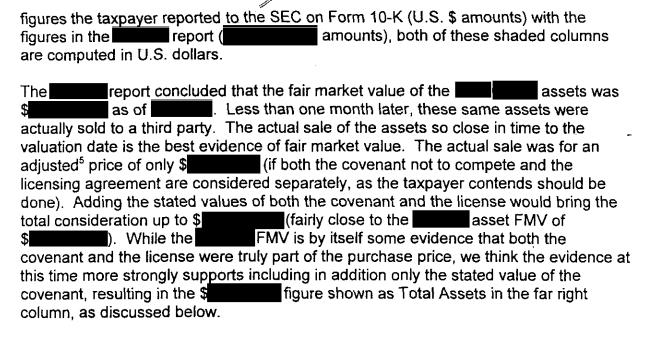
adjustr of "closur severa an ord of the	exceeded by almost valued at ments to the values of assets and liabilities, added to its calculation of the costs." The report (p.) designed payable in the event the Company derly liquidation of the physical assets." report adjusted intercompany account to personal subsidiary of a private ment assigned the following values to the	In addition to less shown on the Total Liabilities scribes this amount of the Liabilities and labeled also we have also we	s works ount as "works ations at tote down the fig	for force related and began book value ure.2 The
	1=\$ \$1=DM	sales cor	ntract	
	Assets		US\$	
	§ 6 subpara. 3 (a) inventory			
	§ 6 subpara. 3 (b) other assets and liabilities		· .	•
	§ 6 subpara. 3 (c) name rights			
	real property			
:	Sales contract total			
	Non-Competition Commitment			
	Licensing Agreement			
1	Total consideration			
that un employ appare	law all employment agreent yees will sently, the sale of all the operating assets le of these assets was disclosed in According to the Form 10-K,	of a business r	with the affe Under results in the 10-K for the T a real proper	cted law, YE
fro	The major components of the asset wrom and (2) Net fixed asset			reduced to

Per Repo	FMV	\$ values (x 1000) per sales			
Assets	Book Values	FMV Adjustment s	FMV	converted to \$ (x 1000)	contract and SEC Form 10- K ³
Cash and Accts receivable					
Inventory					
Other current assets					
Goodwill					
Net fixed assets					
Other assets					
Sales proceeds					
Retained real property interest					
Covenant not to compete					
Total Assets					
Liabilities					
Third party liabilities⁴					
Intercompany accts payable					
Closure costs					
Total Liabilities					

The SEC Form 10-K did not state the amount of state intercompany accounts payable. The intercompany accounts payable amount is taken from the report. This is the only figure in this column not taken from the sales agreement or from the Form 10-K.

This amount equals the total of the following separately-listed liabilities in the report: Accounts payable; Accrued expenses; Taxes and notes payable; Current part of long-term debt; Long-term debt; and Other liabilities.





Many court cases have considered whether a stated value for a covenant not to compete should be respected as part of a sale of assets. Where it is one of the parties to an agreement that is trying to disavow the terms of the agreement, the courts consider what level of proof should be required to disavow one's own agreement. Where the Commissioner challenges the covenant, however, courts analyze the substance of the transaction. The Tax Court has described this analysis as follows:

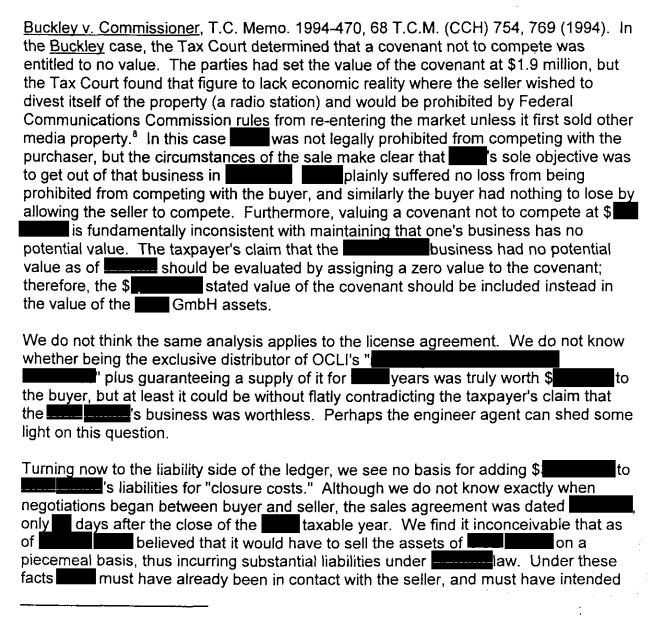
The fact that a taxpayer has allocated a specific amount to a covenant not to compete is not controlling for tax purposes. <u>Lemery v. Commissioner</u>, 52 T.C. 367, 375 (1969), <u>affd. per curiam</u>, 451 F.2d 173 (9th Cir. 1971). In order for the form in which the parties have cast their transaction to be respected for tax purposes, the covenant not to compete must have some independent basis in fact or some arguable relationship with business reality such that reasonable

⁵ In order to compare apples with apples, we have added to the sales proceeds the values the taxpayer put on assets that were included in the valuation but which were not sold (<u>i.e.</u>, cash and accounts receivable and the retained real property interest).

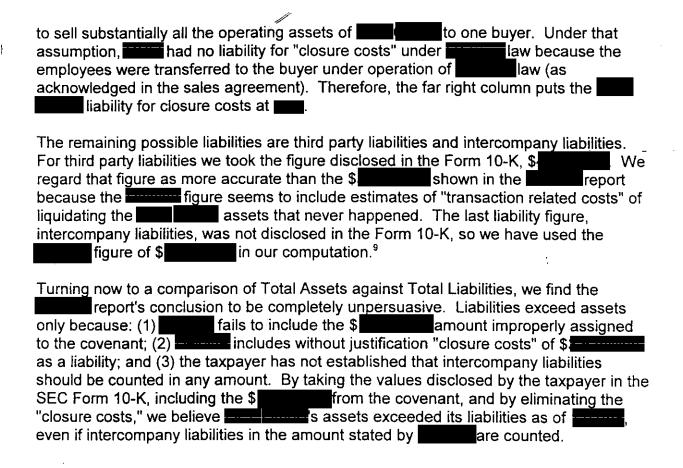
⁶ The context of these cases is typically the attempt by either the Commissioner or one of the parties to a contract to either enforce or disregard the terms of the contract, with the underlying dispute usually involving ordinary versus capital gain. While the context of this case differs, we think the same principles apply to determine whether the covenant should be respected.

⁷ See, <u>e.g.</u>, <u>Commissioner v. Danielson</u>, 378 F.2d 771 (3d Cir. 1967), <u>cert.</u> denied 389 U.S. 858 (1967).

men, genuinely concerned with their economic future, might bargain for such an agreement. Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961), affg. 34 T.C. 235 (1960). This test is commonly referred to as the "economic reality" test. See Patterson v. Commissioner, 810 F.2d 562, 571 (6th Cir. 1987), affg. T.C. Memo. 1985-53. An allocation to a covenant not to compete lacks economic reality where there is no showing that the seller would experience a loss comparable to the amount supposedly paid for the covenant such that it would bargain for substitute compensation in that amount or that the buyer would lose such an amount were the seller to compete against it. See Forward Communications Corp. v. United States, 221 Ct. Cl. 582, 608 F.2d at 493-494.



⁸ The Tax Court also found, under different facts, that a second covenant did have value, though much less than the contract stated.



⁹ This figure is accepted for illustrative purposes only, since under some circumstances we might argue that all intercompany liabilities should be treated as equity, not as liabilities at all. We would need to know when the intercompany liabilities arose, whether formal documents evidence these liabilities, etc. See <u>Flint Industries v. Commissioner</u>, T.C. Memo. 2001-276. We understand the taxpayer has not provided the information needed to make this sort of analysis.

Since we believe has not established tha	t was insolvent as of
, we do not consider whether the	business had potential value as of
. Therefore, we do not consider whether	er the "check-the-box" election can serve
as an "identifiable event" for purposes of section	on 165(g).

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By:_______BRYCE A. KRANZTHOR Attorney (LMSB)